LIBRARY
SUPREME COURT, U. S.
DEC 22 1966
JOHN F. DAVIS, CLERK

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1966

No. 893

SNYDER BROTHERS COMPANY,
Petitioner,

vs.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

FURMAN SMITH
KIRK MCALPIN
434 Trust Company of Georgia Building
Atlanta, Georgia 30303
Counsel for Petitioner

E. L. MENDENHALL, INC., 926 Cherry Street, Kansas City, Mo. 64106, HArrison 1-3030

INDEX

Citations to Opinions Below 1

Jurisdiction 2

Question Presented 2

Statute Involved 2

Statement 3

Reasons for Granting Writ 6

Conclusion 19

Appendix A—

Opinion of United States Court of Appeals, Fifth Circuit A1

Judgment of the United States Court of Appeals, Fifth Circuit A23

Opinion of the United States Court of Appeals, Fifth Circuit, Denying Rehearing A24

Appendix B—

Opinion of Court of Appeals, Second Circuit, in Commissioner v. O.P.P. Holding Corp. A26

TABLE OF CASES

Byrd & Sons Sales Corp. v. *Tobin*, 78 F.2d 371, 100 A.L.R. 654 (8th Cir. 1935) 18

Clyde Bacon, Inc., 4 T.C. 1107 (1945), acq. 1945 C.B. 1 10

Commercial Mortgage & Finance Corp. v. *North American Investors, Inc.*, 111 Ga. App. 355, 141 S.E.2d 768 (1965) 17, 19

Commissioner v. *O.P.P. Holding Corp.*, 76 F.2d 11 (2d Cir. 1935), affirming 30 B.T.A. 337 (1934) 10, 11, 12, 13

Commissioner v. *Page Oil Co.*, 129 F.2d 748 (2d Cir. 1942) 10, 13

Dobson v. *Commissioner*, 320 U.S. 489 (1943) 6, 7

Gregory v. *Helvering*, 293 U.S. 465 (1935) 5, 9, 10

In re Dodge-Freedman Poultry Co., 148 F. Supp. 647 (D.N.H. 1956), aff'd per curiam sub nom. *Dodge-Freedman Poultry Co.* v. *Delaware Mills, Inc.*, 244 F.2d 314 (1st Cir. 1957) 18

John Kelley Co. v. *Commissioner*, 326 U.S. 521 (1946) 6, 7, 8, 9, 10, 12, 13, 15

Kraft Foods Co. v. *Commissioner*, 232 F.2d 118 (2d Cir. 1956) 10, 12, 13

R. M. Gunn, 25 T.C. 424 (1955), aff'd, 44 F.2d 408 (10th Cir. 1957) 16

Rowan v. *United States*, 219 F.2d 51 (5th Cir. 1955) 14, 16

STATUTES

28 U.S.C. § 1254 (1) 2

28 U.S.C. §§ 1340, 1346(a)(1) 4

§ 163(a), Internal Revenue Code of 1954 ..... 2, 7

OTHER AUTHORITIES

Everett, *Subordinated Debt—Nature and Enforcement*, 20 Bus. Law. 953 (1965) 15, 18, 19

11 Fletcher, *Corporations*, § 5324 (1958 rev.) 12

Golin, *Debt Subordination As a Working Tool*, 7 N.Y. Law Forum 370 (1961) 15

Johnson, *Subordinated Debentures: Debt That Serves As Equity*, 10 J. Finance 1, 4-9 (1955) 15

Rev. Proc. 64-31, 1964-2 C.B. 947 8

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1966

No. .....

SNYDER BROTHERS COMPANY,
Petitioner,

vs.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Snyder Brothers Company prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit, entered in the above-entitled case on July 26, 1966.

CITATIONS TO OPINIONS BELOW

The United States District Court for the Northern District of Georgia, Gainesville Division, issued no opinion. The opinion of the Circuit Court of Appeals, printed in Appendix A hereto, *infra*, p. A1, is reported in 66-2 U.

S.T.C. ¶ 9573 and 18 A.F.T.R.2d 5316. The opinion of the Circuit Court of Appeals denying rehearing printed in Appendix A hereto, *infra*, p. A24, is reported in 18 A.F.T.R. 2d 5707. The official reports of these opinions have not yet appeared.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on July 26, 1966 (R. 117); Appendix A, *infra*, p. A23. Petition for rehearing and for rehearing *en banc* was timely filed on August 16, 1966. (R. 118.) Rehearing was denied on September 27, 1966 (R. 141); Appendix A, *infra*, p. A24. Mandate was issued on October 5, 1966. (R. 117); Appendix A, *infra*, p. A23. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1)

QUESTION PRESENTED

Whether the debentures issued by petitioner, which state an unconditional and legally enforceable obligation to pay principal and interest on fixed dates, and which the Government admits were intended to create bona fide debt, fail to qualify as "indebtedness" under § 163(a) of the Internal Revenue Code of 1954, *as a matter of law*, solely because they were initially issued to stockholders and are subordinated.

STATUTE INVOLVED

The statutory provision involved is § 163(a) of the Internal Revenue Code of 1954, which provides:

> "(a) GENERAL RULE.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."

STATEMENT

From April 1, 1947 until November 30, 1957, two brothers, Franklin D. Snyder and Floyd R. Snyder, carried on the business of manufacturing industrial furniture finishes as a partnership operating under the name of Snyder Brothers Company. (R. 83.) This partnership was highly successful, having average annual earnings for 1955 through 1957 in excess of $87,000. (R. 84.)

On November 30, 1957 the two brothers transferred substantially all of the assets of their partnership to petitioner, a new Georgia corporation which they had organized with the name of Snyder Brothers Company [hereinafter petitioner is referred to as the "Company"]. In exchange for partnership assets having a book value of $450,382.87, the Company assumed the liabilities of the partnership in the amount of $202,568.13 and issued to the brothers capital stock of the Company having a par value of $100,000. It also issued to the brothers "6% Subordinated Debentures" [hereinafter referred to as the "debentures"] in the principal amount of $140,000. The book value of the assets transferred to the Company exceeded by $7,814.74 the sum of the liabilities assumed, the par value of the stock issued, and the stated principal amount of the debentures. This amount was carried on the Company's books as "paid-in surplus." Having been equal partners in the transferring partnership, each brother received one-half of the capital stock and one-half of the debentures. (R. 83.) The Company's ratio of debt to equity was approximately 1.3 to 1.

The debentures[1] constituted the absolute, fixed and unconditional obligation of the Company to pay interest semi-

1. A sample debenture is printed as an appendix to the opinion of the Court of Appeals for the Fifth Circuit [hereinafter cited as "Opinion"], R. 105, set forth herein in Appendix A, *infra*, p. A13.

annually at six per cent per annum and to repay principal on December 1, 1977, twenty years later. They were subordinated to the present indebtedness of the Company and to all future indebtedness not specifically subordinated. They contained no restrictions on transfer. Debenture holders were given no voting rights whatsoever with respect to the Company.

The debentures have at all times been treated as indebtedness on the books of the Company, with the semiannual payments shown as interest, and all such payments have been made promptly when due. (R. 83.) Further, the intent of the parties to create valid indebtedness is not disputed.[2]

The Company sought to deduct the semiannual payments as interest for federal income tax purposes, but the Commissioner of Internal Revenue disallowed the deductions on the ground that the debentures were equity investments, rather than indebtedness, with the result that the semiannual payments constituted dividends and not interest within the meaning of § 163(a) of the Internal Revenue Code of 1954. The Company paid the assessed deficiency and instituted suit for refund, invoking the jurisdiction of the United States District Court under 28 U.S.C. §§1340 and 1346 (a)(1). (R. 4-7, 12-14.)

At the trial the Company introduced a stipulation of facts,[3] a sample debenture, its corporate minute and stock

---

2. According to the Government:

"[I]n the instant case *the intent of the parties is not at issue.* . . Whether the 'Debentures' constituted a capital investment depends not on a determination of anyone's intent but rather on a characterization of the instrument here involved." (Emphasis added).

Reply Brief for the Appellant at 10, quoted in footnote 1 of the dissenting opinion, R. 110, Appendix A, *infra*, p. A17.

3. The stipulation of facts is set forth in the Record at 82-85.

books, its federal income tax returns and audit reports for the years in question, and the final federal income tax return of the partnership. (R. 21-40.) Following introduction of this documentary evidence, and without oral testimony, the Company rested. The United States [hereinafter referred to as the "Government"] then moved for a directed verdict, which the court denied (R. 42 & 50), and the Government rested without introducing any evidence whatsoever. (R. 50.) The Company then made a motion for a directed verdict which the court granted (R. 54-57), and judgment was entered for the taxpayer. (R. 62, 63.) The Government subsequently filed a motion for judgment notwithstanding the verdict, and, in the alternative, for a new trial. (R. 64-69.) This motion was denied. (R. 70-73.)

The Government appealed the decision of the District Court to the United States Court of Appeals for the Fifth Circuit. (R. 74.) The Fifth Circuit majority, over Judge Gewin's vigorous dissent, reversed the trial court not for a new trial but for entry of judgment in favor of the Government. (R. 104.) According to the majority, "the issue here to be decided is one of law"[4] (R. 94.), depending "solely upon our construction of the instrument."[5] (R. 92.) Moreover, the court summarized, citing *Gregory* v. *Helvering*[6], that:

> "The net of the matter is that for us to construe this document under these circumstances as 'an indebtedness' would be to give substance to a 'transaction [which] upon its face lies outside the plain intent of the statute.' "[7] (R. 103-104.)

---

4. Opinion, Appendix A, *infra*, p. A4.
5. Opinion, Appendix A, *infra*, p. A2.
6. 293 U.S. 465, 470 (1935).
7. Opinion, Appendix A, *infra*, p. A12.

Upon entry of judgment for the Government (R. 117), the Company made a timely petition for rehearing and for rehearing before the court *en banc*. (R. 118.) With Judge Gewin again dissenting, the Circuit Court denied the Company's motion with a brief opinion, which concluded:

> "As a matter of law, the debentures here in question do not create a 'debt' within the contemplation of the applicable statute."[8] (R. 141.)

REASONS FOR GRANTING WRIT

1. The decision of the United States Court of Appeals for the Fifth Circuit below is in conflict with the decision of the Supreme Court in *John Kelley Co.* v. *Commissioner*, 326 U.S. 521 (1946), the only decision of this Court with respect to the question presented by this case. In *John Kelley Co.* the taxpayer issued to its stockholders 20-year debentures, subordinated to all other creditors, with interest payable only if and to the extent earned each year, not cumulative. The Supreme Court reversed the Court of Appeals for the Seventh Circuit and affirmed the Tax Court's decision that interest paid on the debentures was deductible.

Under the rule laid down in the present case by the court below, the deduction of interest on the debentures in *John Kelley Co.* would have been disallowed as a matter of law.

The Fifth Circuit majority dismissed *John Kelley Co.* v. *Commissioner* with the statement that "this case has no precedential value beyond that of any other decision of the Tax Court,"[9] because it was based on the *Dobson* rule.[10]

---

8. Opinion of the Court of Appeals for the Fifth Circuit denying rehearing [hereinafter cited as "Opinion denying rehearing"], R. 140, set forth herein in Appendix A, *infra*, p. A24.

9. Opinion, Appendix A, *infra*, p. A9.

10. *Dobson* v. *Commissioner*, 320 U.S. 489 (1943).

In taking this position, however, the Fifth Circuit has construed too narrowly the import of *John Kelley Co.* If this Court had considered that the characteristics of the debentures in *John Kelley Co.*, coupled with stockholder ownership, placed such debentures "outside the plain intent of the statute," as a matter of law, it could and would have said so, notwithstanding the *Dobson* rule. The characteristics of the securities under consideration in *John Kelley Co.* placed them much closer to "preferred stock" than do the characteristics of the debentures in the instant case. Nevertheless, this Court in *John Kelley Co.* expressly rejected the idea that the status of such securities under the income tax law could be determined as a matter of law.[11] The fact that this Court's decision in *John Kelley Co.* was based on the *Dobson* rule points up the conflict between that decision and the present one, rather than preventing conflict.

2. If the lower court should be correct in dismissing *John Kelley Co.* v. *Commissioner* as having "no precedential value beyond that of any other decision of the Tax Court," then that premise is a compelling reason for this Court to grant certiorari—for there is no other Supreme Court decision on the important question of what constitutes corporate indebtedness under § 163(a). As is generally recognized, there is probably more confusion with respect to this question than with respect to any other point of federal tax law. The conflict of circuit court decisions, discussed hereinafter, combined with the superabundance of lower court decisions,[12] and articles by respected commentators,[13]

11. 326 U.S. at 527.

12. Some of the most recent decisions which have struggled with the problem of whether nominal debt constitutes indebtedness within the meaning of § 163(a) are: *Affiliated Research, Inc.* v. *United States*, 351 F.2d 646 (Ct. Cl. 1965); *Doornbosch Bros.*, 46 T.C. No. 17 (1966); *W. C. Gamman*, 46 T.C. 1 (1966);

demonstrate the uncertainty of this area. The Treasury has done nothing to lessen the confusion, either among taxpayers or among its own agents. It has published absolutely no Regulations on the subject. It has issued no published rulings and has stated that it will not issue any private rulings on the question.[14] Moreover, notwithstanding taxpayer's confidence that *John Kelley Co.* is a precedent of current vitality, at least with respect to the question presented by the instant case, it must be admitted that this

---

Irbco Corp., 25 T.C.M. 359 (1966); *Jack Daniel Distillery*, 667 CCH Fed. Tax Rep. ¶ 8154 (Ct. Cl. Comm'r Rep. 1966); *John Town, Inc.*, 46 T.C. 107 (1966); *Obermeyer* v. *United States*, 66-2 U.S.T.C. ¶ 9728 (S.D. Ohio 1966); *Old Dominion Plywood Corp.*, 25 T.C.M. 678 (1966); *A. L. Stanchfield*, 24 T.C.M. 1681 (1965); *Stone Mountain Grit Co.*, 65-2 U.S.T.C. ¶ 9702 (N.D. Ga. 1965); *Wood Preserving Corp.*, 347 F.2d 117 (4th Cir. 1965); *Wynnefield Heights, Inc.*, 25 T.C.M. 953 (1966).

13. The following articles constitute a sampling of the flood of periodical literature in which the commentators attempt to find guidelines in this area: Aarons, *Debt v. Equity: Special Hazards in Setting Up the Corporate Capital Structure*, 23 J. Taxation 194-97 (Oct. 1965); Bittker, *Thin Capitalization: Some Current Questions*, 34 Taxes 830 (Dec. 1956); Caplin, *The Caloric Count of a Thin Incorporation*, 17th Ann. N.Y.U. Tax Inst. 771 (1959); Dixon, *The Interest-Dividend Syndrome: What Are the Criteria Now?* 24th Ann. N.Y.U. Tax Inst. 1267-90 (1966); Farrar, *Is Interest Deductible Only If the Debt Has a Nontax Profit Purpose*, 13 J. Taxation 258 (Nov. 1960); Gerver, *De-Emphasis of Debt-Equity Test for Thin Corporations Requires New Defense Tactics*, 23 J. Taxation 28-31 (July 1965); Goldstein, *Corporate Indebtedness to Shareholders: "Thin Capitalization" and Related Problems*, 16 Tax. L. Rev. 1 (Nov. 1960); Hellerstein, *Tax Court Approach to Thin Incorporation Defended*, 10 J. Taxation 88 (Feb. 1959); Hertz, *Getting Property Into and Out of the Corporation*, 21st Ann. N.Y.U. Tax Inst. 347 (1963); Lewis, *110,000 to Zero Debt-Equity Ratio No Bar to Finding Debtor-Creditor Relationship Between Corporation and Stockholder*, 15 Syracuse L. Rev. 118-122 (Fall 1963); Morris, *Intent Test Grows As Determinant on Thin Incorporation Safety; Recent Cases Guide*, 13 J. Taxation 130 (Sept. 1960); Weirs, *The Labyrinth of the Thin Corporation*, 40 Taxes 568 (Jul. 1962); Weyber & Weithorn, *Capital Structure of New Corporations*, 16th Ann. N.Y.U. Tax Inst. 277 (1958); *New Thin Incorporation Threat: Repayment of Guaranteed Bank Loans Treated As Dividends*, 23 J. Taxation 197-99 (Oct. 1965).

14. Rev. Proc. 64-31, 1964-2 C.B. 947.

Court's use of the *Dobson* rule in *John Kelley Co.* makes it difficult for taxpayers, the lower courts and the Commissioner to use it as a guide. Thus, whether or not the lower court is correct regarding *John Kelley Co.*, its comment does point up the great need for clarification in an area so confusing as to conflict with the guaranty inherent in the American system of law that a citizen be reasonably apprised, in advance, of the consequences of his acts. For this reason, this Court should grant certiorari to examine and clarify this important question of federal tax law.

3. The Fifth Circuit is also in conflict with *John Kelley Co.* v. *Commissioner, supra,* when it bases the decision in the instant case on the rationale of *Gregory* v. *Helvering,* 293 U.S. 465 (1935). The reasoning of the court below apparently is that even though an instrument is regular in form and constitutes valid indebtedness for commercial purposes, *and even though the intent of the parties to create a valid indebtedness is unquestioned,* some doctrine stemming from *Gregory* v. *Helvering* may prevent it from being recognized as indebtedness for tax purposes.[15] Whatever else may be said about the decision of this Court in *John Kelley Co.* v. *Commissioner,* it certainly rejected the application of *Gregory* v. *Helvering* to the determination of whether debentures having all the features of the debentures in this case constituted indebtedness for tax purposes. This Court there said:

> "There is not present in either situation [the situation of either of the debentures involved in this case] the wholly useless temporary compliance with statutory literalness which this Court condemned as futile, as a matter of law, in *Gregory* v. *Helvering,* 293 U.S. 465. The demonstrated possibility of sales by the holders

15. See Opinion, Appendix A, *infra,* p. A6.

of the obligations to persons other than stockholders alone proves the differentiation."[16]

Thus the majority opinion below, in relying on the rationale of *Gregory* v. *Helvering*, is clearly contrary to the views of this Court in its only applicable decision.

4. The decision of the majority in the Court of Appeals for the Fifth Circuit places that court in clear and irreconcilable conflict with the well-established rule in the Second Circuit that subordinated indebtedness owed to stockholders does not, as a matter of law, fail to qualify as indebtedness for tax purposes. *Commissioner* v. *O.P.P. Holding Corp.*, 76 F.2d 11 (2d Cir. 1935), *affirming* 30 B.T.A. 337 (1934); *Commissioner* v. *Page Oil Co.*, 129 F.2d 748 (2d Cir. 1942); *Kraft Foods Co.* v. *Commissioner*, 232 F.2d 118, 125-26 (2d Cir. 1956). Moreover, this decision is also in clear conflict with the announced position of the Commissioner of Internal Revenue. See the Commissioner's acquiescences in *O.P.P. Holding Corp.*, *supra*, acq. 1959-1 C.B. 6, and in *Clyde Bacon, Inc.*, 4 T.C. 1107 (1945), acq. 1945 C.B. 1.

The leading decision of the Second Circuit is *Commissioner* v. *O.P.P. Holding Corp.*, *supra*, in which that court allowed the interest deduction despite facts which were far more favorable to the Government than in the instant case.[17] In *O.P.P. Holding Corp.*, the stockholders of an existing corporation transferred all their stock to a new corporation in exchange for *all* of the stock, having a stated value of $10,000, plus *all* of the debenture bonds, in the amount of $250,000, of the new corporation. The debentures were subordinated to the claims of all other

16. *John Kelley Co.* v. *Commissioner*, *supra* at 525.

17. For convenience, the opinion of the Court of Appeals for the Second Circuit in *Commissioner* v. *O.P.P. Holding Corp.* is printed as Appendix B, *infra*, p. A26.

creditors, and the issuing corporation at its option could suspend or defer the payment of interest until final maturity. The debentures were for a term of 25 years. The Board of Tax Appeals held that the debentures constituted indebtedness[18] and the Second Circuit Court of Appeals affirmed, saying:

> "We do not think it fatal to the debenture holder's status as a creditor that his claim is subordinated to those of general creditors. The fact that ultimately he must be paid a definite sum at a fixed time marks his relationship to the corporation as that of creditor rather than shareholder. The final criterion between creditor and shareholder we believe to be the contingency of payment. The shareholder is entitled to nothing, prior to liquidation, except out of earnings. . . . These debenture bondholders were not so limited. . . . This distinction marks the vital difference between the shareholder and the creditor."[19]

The majority opinion attempts to distinguish *O.P.P. Holding Corp.* solely on the "very significant circumstance" that there the issuing corporation "obligated itself to pay no dividends to its stockholders as long as any interest payments on the debenture bonds remained unpaid."[20] The majority fails to mention, however, that this obligation was coupled with a provision permitting the corporation at its option to defer payment of any interest on the debentures until the final maturity, twenty-five years from date of issue.[21] In the instant case the Company has no right to defer interest. It is unconditionally obligated to pay interest semiannually. Having no option to defer

18. 30 B.T.A. 337, 341 (1934).

19. *Commissioner* v. *O.P.P. Holding Corp.*, *supra* at 12, Appendix B, *infra*, p. A28.

20. Opinion, Appendix A, *infra*, p. A8.

21. *Commissioner* v. *O.P.P. Holding Corp.*, *supra* at 12, Appendix B, *infra*, p. A28.

interest, a provision that the Company could not pay dividends while deferring interest would be meaningless, since, as a matter of law, the corporation could not pay dividends while in default in the payment of interest.[22]

The most recent statement of the position of the Second Circuit is in *Kraft Food Co.* v. *Commissioner*, 232 F.2d 118 (2d Cir. 1956). There a subsidiary corporation issued to its parent a dividend of debentures in the amount of $30,000,000, with the admitted primary motivation of obtaining a tax benefit. In answer to the Commissioner's contention that the debentures were subordinated to general creditors and therefore not indebtedness, the Second Circuit stated:

> "Subordination to general creditors is not necessarily indicative of a stock interest. Debt is still debt despite subordination."[23]

For this proposition the Second Circuit relied upon *John Kelley Co., supra*, as well as its prior decisions in *O.P.P. Holding Corp.* and *Commissioner* v. *Page Oil Co., supra.*

The Commissioner of Internal Revenue originally announced a nonacquiescence in the decision of the Board of Tax Appeals in *O.P.P. Holding Corp.* XIII-2 C.B. 27 (1934). Subsequently, however, this nonacquiescence was withdrawn and an acquiescence was substituted. 1959-1 C.B. 5. The fact that the Commissioner in 1959 withdrew the previous nonacquiescence, after the lapse of 25 years, and announced his acquiescence is significant. It demonstrates that the acquiescence was the result of a studied policy decision by the Commissioner and was not merely a routine acquiescence. Moreover, it further demonstrates that the decision of the Second Circuit in *O.P.P. Holding Corp.* has

---

22. See 11 Fletcher, *Corporations*, § 5324 (1958 rev.).

23. *Kraft Food Co.* v. *Commissioner, supra* at 125-26.

increased rather than diminished in significance with the passage of time.

The conflict between the instant decision and the decisions in the Second Circuit is direct, and the cases cannot be reconciled. The Second Circuit cases clearly hold that the fact that stockholder-owned debentures are subordinated to general creditors is not "fatal to the debenture holder's status as a creditor."[24] On the other hand, the Fifth Circuit majority holds that the combination of stockholder ownership and subordination to all other creditors places debentures "outside the plain intent of the statute," as a matter of law.

The direct conflict between the instant decision and the decisions of the Second Circuit is not lessened by the fact that the majority opinion points to other "characteristics" of the debentures which are said to have influenced the decision.[25] The strong implication is that these characteristics are unique and set the Snyder debentures apart from the usual form of subordinated debentures. This, however, is not the case. These characteristics are common in cases involving subordinated debentures owned by stockholders. For example, all four of the characteristics listed were present in *John Kelley Co.* v. *Commissioner, supra.* In *Kraft Food Co.* v. *Commissioner, supra,* all were present, except that the term was fifteen years instead of twenty. In *Commissioner* v. *Page Oil Co., supra,* the notes involved were payable on demand after five years, but each of the other characteristics were present. In *O.P.P. Holding Corp.* there was a limitation on dividends while interest was deferred, as discussed above. Otherwise, all the characteristics were present. In *Clyde Bacon, Inc.,* 4 T.C. 1107

24. *Commissioner* v. *O.P.P. Holding Corp., supra* at 12, Appendix B, *infra,* p. A28.

25. Opinion, Appendix A, *infra,* p. A8.

(1945), acq. 1945 C.B. 1, all four characteristics were present. The fact is that the "other characteristics" of the debentures mentioned by the majority opinion are characteristic of and will be present in virtually all subordinated indebtedness. As a practical matter, the reference to them merely obscures from the casual reader that the court has held that subordinated indebtedness issued to stockholders is not valid for tax purposes.

Another feature of the majority opinion which might obscure the revolutionary character of this decision is the treatment of *Rowan* v. *United States*, 219 F.2d 51 (5th Cir. 1955), where stockholder advances to an insolvent corporation were upheld as indebtedness. The court first indicates that the question in the instant case is not the same as in *Rowan*, where the issue was the intent of the parties.[26] Later, however, the court compares the two cases for the purpose of pointing out that "a number of things are present in the case before us that we specifically noted were not present in the *Rowan* case."[27] The facts and circumstances used for the comparison between *Rowan* and this case are admittedly significant where the issue for determination is whether the parties intended to create a bona fide indebtedness. The court below repeatedly states, however, that this is not the issue here. Such facts are not significant to a determination of whether these debentures issued to stockholders failed to qualify as indebtedness as a matter of law. If they did fail to qualify as a matter of law, then the question of intent present in *Rowan* is never reached. If they did not fail to qualify as indebtedness as a matter of law, then the facts and circumstances that bear on intent would become relevant, except that the Government in the instant case has conceded the issue of intent.

---

26. Opinion, Appendix A, *infra*, p. A6.
27. Opinion, Appendix A, *infra*, p. A11.

Stripped of its dictum and irrelevant discussion, the holding of the decision below can only be that subordinated debt issued to stockholders does not, as a matter of law, constitute indebtedness within the meaning of § 163(a) of the Internal Revenue Code. The Fifth Circuit cites no authority in support of this holding, and to our knowledge none exists. Such holding conflicts with the several decisions of the Second Circuit, discussed above. This Court should grant certiorari to consider this revolutionary departure from established precedent and to dispel the uncertainty which will result from the decision of the Fifth Circuit in this case.

5. The question presented by the instant case is of great importance to many taxpayers and to the general business community. In reliance upon *John Kelley Co.* v. *Commissioner*, the decisions of the Second Circuit discussed above, and the announced policy of the Commissioner, many taxpayers who are stockholders of corporations have made investments in subordinated debentures of such corporations. As indicated by Judge Gewin in his dissent below, "subordination is not condemned but is an approved business practice."[28] It has grown in usage and importance in recent years.[29] This is particularly true in the case of closely held corporations, for it is customary for banks and lending institutions to require stockholders of such corporations to subordinate any stockholder-owned indebtedness.

Heretofore it has been recognized that subordination of stockholder-owned debt was a relevant factor in the determination of whether such debt constituted "indebted-

28. Opinion, Appendix A, *infra*, p. A20.

29. See, *e.g.*, Everett, *Subordinated Debt—Nature and Enforcement*, 20 Bus. Law. 953 (1965); Johnson, *Subordinated Debentures: Debt That Serves As Equity*, 10 J. Finance 1, 4-9 (1955); Golin, *Debt Subordination As a Working Tool*, 7 N.Y. Law Forum 370 (1961).

ness" for tax purposes. This determination, however, has been viewed as a question of fact, turning on the intent of the parties as gleaned from all the facts and circumstances.[30] No court has previously held that subordinated debt owned by stockholders cannot qualify as "indebtedness" for tax purposes, as a matter of law, even though it is admitted that the parties intended to create bona fide indebtedness. The Government and the court below both disavow that this case turns on the intent of the parties and agree that the only question involved is whether the debentures *on their face* constitute indebtedness when issued to stockholders.[31]

The direct result of the decision below to the Company and the holders of its debentures is to deny to the Company the deduction for interest paid on the debentures. The ultimate result, however, both to the taxpayers here and to many other taxpayers, is much more drastic. When debt instruments are held to constitute "stock" for tax purposes, the repayment of such debt when it becomes due constitutes the redemption of "stock" for tax purposes. The result in many cases will be that the full amount of the debt repayment will be deemed a dividend, taxable in full as ordinary income. *R. M. Gunn*, 25 T.C. 424 (1955), *aff'd*, 44 F.2d 408 (10th Cir. 1957).

If the drastic penalty that will result from this case is to be imposed on a large number of taxpayers as a result of new judicial interpretation, when taxpayers have relied on a contrary interpretation over a long period of years, then such penalty should be imposed only by this Court after careful consideration.

---

30. See, *e.g.*, *Rowan* v. *United States*, 219 F.2d 51, 54 (5th Cir. 1955).

31. See note 2, *supra*. Opinion denying rehearing, Appendix A, *infra*, p. A25, and Opinion, Appendix A, *infra*, pp. A2 and A5-A6.

6. The decision below is based upon a determination with respect to the rights of holders of the debentures which is in conflict with, and which fails to follow, a recent decision of the Georgia Court of Appeals. Here the court below agreed with the Government that because of the subordination to general creditors holders of the debentures are "practically helpless"[32] if the Company should choose to default in its obligations on the debentures, for whatever reason. This argument is based on the premise that holders of the subordinated debentures could not take legal action to enforce the obligations of the Company on the debentures so long as there were obligations to other creditors that were due and unpaid. Such premise is not valid. This is clearly shown by *Commercial Mortgage & Finance Corp.* v. *North American Investors, Inc.*, 111 Ga. App. 355, 141 S.E.2d 768 (1965). There a suit was brought by the holder of a promissory note which was subject to a subordination agreement, providing, among other things, that the right of the payee to demand or receive payment was subordinated to the claims of "all present and future creditors" of the maker. The Georgia Court of Appeals held that such subordination provision did not preclude a suit on the note, without regard to whether there were any outstanding claims of other creditors. This holding is in accord with general law. Subordination provisions, as expressly stated in the debentures here, are solely for the purpose of defining the relative rights of the holders of superior and subordinated indebtedness, and the debtor cannot assert such provision as a defense to a suit on subordinated indebtedness. Upon default of subordinated indebtedness, the holder can file suit against the debtor, obtain a judgment, and proceed to levy on the property of the debtor or take other appropriate legal ac-

32. Opinion, Exhibit A, *infra*, p. A10.

tion to collect the judgment. Holders of superior indebtedness under such circumstances can take appropriate action to enforce the subordination provisions in their favor. They can proceed in a court of equity or in a bankruptcy court to set up an equitable lien or constructive trust on any payment that would be recovered by the holder of the subordinated indebtedness on his judgment, to the extent necessary to satisfy the superior indebtedness. This remedy does not affect the amount to be paid by the debtor, but simply means that amounts recovered from the debtor go first to the holders of superior indebtedness. Once their claims are satisfied in full, the remaining property of the debtor becomes available for payment to the holders of subordinated indebtedness. If a holder of superior indebtedness chooses not to enforce his rights, this does not prevent the holders of subordinated indebtedness from enforcing their rights, but would merely be a waiver by the superior indebtedness of its right to prior payment.[33]

In spite of the invalidity of the premise upon which the argument of the Government is based, the majority opinion in the instant case accepts this argument, without citing any authority whatsoever and without making any reference to the decision of the Georgia Court of Appeals discussed above. The error of the majority below in this respect is emphatically pointed out by Judge Gewin in his dissent, where he says:

> "The majority is simply in error when it agreed with the Government that the debenture holders 'are practically helpless' if the taxpayer refuses to pay principal or interest when due, 'for any reason.' The

33. *Byrd & Sons Sales Corp.* v. *Tobin*, 78 F.2d 371, 100 A.L.R. 654 (8th Cir. 1935); *In re Dodge-Freedman Poultry Co.*, 148 F. Supp. 647 (D.N.H. 1956), *aff'd per curiam sub nom. Dodge-Freedman Poultry Co.* v. *Delaware Mills, Inc.*, 244 F.2d 314 (1st Cir. 1957); see Everett, *Subordinated Debt—Nature and Enforcement*, 20 Bus. Law. 953, 958 (1965).

law of Georgia is clearly to the contrary. A recent Georgia case so holds."[34]

Failure of the court below to follow the decision of the Georgia Court of Appeals in the *Commercial* case, and to follow general law, will have far-reaching effects. The form of the debentures used by Snyder Brothers Company, which is reproduced as an appendix to the opinion below, is in common use.[35] The decision of the court below casts serious doubt on the rights of holders of subordinated indebtedness to enforce such indebtedness, whereas such rights were heretofore well-established. This Court should grant certiorari to eliminate this doubt, and to correct the failure of the court below to recognize and follow Georgia law as established by its courts.

7. Regardless of whether the decision reached by the Fifth Circuit majority was or was not correct, it is one which cries out for review by this Court. Not only did the lower court discard the only Supreme Court decision on what may be the single most litigated point of federal tax law, but its decision conflicts with and calls into serious question an accepted line of appellate and Tax Court authority, recently acquiesced in by the Commissioner, and even casts doubt upon the enforceability of subordinated indebtedness contrary to all previous decisions on that question. The practical import of this decision cannot be overstated. It seems certain to have a devastating impact upon the use of subordinated debt in small corporations and may even curtail its use altogether. Perhaps, as a matter of tax policy, the use of subordination should be subjected to new and detailed scrutiny, but taxpayer submits that it is a far too important

34. Opinion, Exhibit A, *infra*, p. A21.

35. It is substantially identical to the typical debenture quoted in Everett, *Subordinated Debt—Nature and Enforcement*, note 33, *supra* at 956-59.

and well-accepted business practice to be overthrown by the decision of one circuit judge and one district judge, which is contrary to the dissent of one circuit judge and the directed verdict by one district judge.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

FURMAN SMITH

KIRK MCALPIN
434 Trust Company of Georgia Building
Atlanta, Georgia 30303
Counsel for Petitioner

December 20, 1966.

APPENDIX A

IN THE

United States Court of Appeals

FOR THE FIFTH CIRCUIT

No. 22111

UNITED STATES OF AMERICA,
Appellant

versus

SNYDER BROTHERS COMPANY.
Appellee.

Appeal from the United States District Court for the Northern District of Georgia.

(July 26, 1966.)

Before TUTTLE, Chief Judge, GEWIN, Circuit Judge, and HUGHES, District Judge.

TUTTLE, Chief Judge: We have here for determination the question whether certain twenty-year debentures subordinated to all other indebtedness of the issuing taxpayer corporation constitute an "indebtedness" within the meaning of Section 163 of the Internal Revenue Code of 1954, 26 U.S.C.A. §163,[1] the interest upon which is allowed as a federal income tax deduction.

---

1. "Section 163. Interest.
(a) General Rule. There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."

The facts are not in dispute. For a number of years Franklin D. Snyder and Floyd R. Snyder were engaged in the business of manufacturing industrial furniture finishes in Toccoa, Georgia, as a partnership under the name Snyder Brothers Company, in which each was an equal partner. On November 30, 1957, the Snyder Brothers transferred substantially all of the assets of this partnership to the taxpayer, a new Georgia corporation they had organized with the name Snyder Brothers Company. In exchange for the partnership assets that were transferred to the corporation, which had a book value of $450,382.87, the corporation assumed liabilities of the partnership in the amount of $202,568.13, and issued to the Snyder Brothers capital stock with a par value of $100,000, and securities entitled "Subordinated Debentures," with a stated principal amount of $140,000. The excess of the book value of the assets transferred to the corporation over the sum of the liabilities assumed, the par value of the stock issued and the stated principal amount of the "subordinated debentures" issued, amounting to $7,814.74, were shown on the corporation's books as "paid in surplus."

As equal partners in the transferring partnership, the two brothers each received one half of the capital stock and one half of the "subordinated debentures" of the corporation.

In view of the fact that the question before us depends solely upon our construction of the instrument called "subordinated debenture" we quote the language of the document in full as an appendix to this opinion. The principal characteristics of it, however, can be seen by the following brief statement: The total amount of $140,000 was to be paid 20 years from date with interest at 6% per annum payable semiannually, without, however, the right to acceleration of the entire indebtedness upon default of

interest payments. They provided expressly that they should be subordinated to all indebtedness of the corporation, whether already incurred or to be incurred at any time in the future. No limit was placed upon the amount of such prior indebtedness. No limit was placed on the payment of dividends to stockholders. The right of all other creditors to receive payment in full of principal and interest on their claims was provided for in case of liquidation, bankruptcy or insolvency, or in the event of a default in payment of interest or principal to the holders of the "debentures." "Debentures" could be transferred only on the books of the company by proper written assignment executed by the registered holder and presentation of the "debenture" at the office of the company. In other respects the "debentures" were in the form of an absolute promise to pay a fixed principal sum 20 years from date.

Subsequent to the issue of these instruments, the taxpayer made semiannual payments as required therein. These payments were shown as "interest" on the taxpayer's books. The taxpayer sought to deduct the payments as interest for federal income tax purposes. The Commissioner of Internal Revenue disallowed these deductions on the ground that the "subordinated debentures" did not truly represent an "indebtedness" within the meaning of Section 163(a) of the Internal Revenue Code of 1954, but rather represented an investment in the company in the nature of a stock investment. The taxpayer paid the assessed deficiency and in due course instituted this suit for refund in the District Court. In that court, the facts having been stipulated, both parties moved for a directed verdict. The trial court directed a verdict in favor of the taxpayer and following judgment being entered on the verdict, the government subsequently filed a motion for

judgment notwithstanding the verdict, and in the alternative, for a new trial. This motion was denied and this appeal followed.

We conclude that the issue here to be decided is one of law. Upon a careful consideration of the statute and the many decisions of the courts construing it, we conclude that the issue should have been decided in favor of the government. We, therefore, reverse for the entry of a judgment against the taxpayer.

The question whether an advance of money or transfer of property by persons who are the sole stockholders of a corporation to their wholly owned corporation in return for a promise to repay such advances, creates an indebtedness within the contemplation of the Internal Revenue laws, or amounts to contribution to capital or an increase in the capital investment by the stockholders, is not a new one. It has been considered many times by many courts, including this court. After carefully reviewing decisions of the courts struggling with this problem, we conclude that one of the best statements of the problem is contained in an opinion written by Judge Waterman, for the Court of Appeals for the Second Circuit, in *Kraft Food Company* v. *Commissioner of Internal Revenue*, 2 Cir., 232 F.2d 118, at page 123. There the court said:

> "Section 23(b) of the applicable Revenue Acts provides that in computing net income 'there shall be allowed' as a deduction 'all interest * * * indebtedness' (with exceptions not pertinent here). The crucial word, of course, is 'indebtedness.' In general, 'The words, 'interest on indebtedness' should be accorded their usual, ordinary and every day meaning.' Preston v. Commissioner, 2 Cir., 1940, 132 F.2d 763, 765. If they were always accorded that meaning, however, the determination that a particular instrument had created an "indebtedness" enforceable under corporate law

would settle conclusively the treatment for federal tax purposes of any payments made pursuant to the instrument. It is now a commonplace that words have many meanings, each dependent upon their context. Thus, "indebtedness", as used in a federal taxation statute may not carry the same meaning as the same word used in the context of corporate finance. As the Supreme Court has said, 'although an indebtedness is an obligation, an obligation is not necessarily an 'indebtedness' within the meaning of §23(b).' Deputy v. DuPont, 1940, 308 U.S. 488, 497, 60 S.Ct. 363, 368, 84 L.Ed. 416. Our present problem is whether there is some paramount policy of federal tax law which requires in this case that taxpayers payments pursuant to its debentures be considered, for tax purposes, as "dividends" rather than "interest * * * on indebtedness."'

We fully agree with this statement of the issue. We also agree with the following comment, which answers the appellee's contention here that the government does not attempt to place its right to a reversal by proving different "intent" of the parties to the transaction than as indicated on the face of the documents:

'Numerous cases are concerned with the question whether a particular interest in a corporation is an equity or debt interest. The vast majority of these cases have involved "hybrid securities"—instruments which had some of the characteristics of a conventional equity issue. When such hybrid securities are involved the problem of characterization is one of considering each case on all of its facts. See John Kelley Co. v. Commissioner (Talbot Mills v. Commissioner), 1946, 326 U.S. 521, 698, 66 S.Ct. 299, 90 L.Ed. 278. In the present case, however, the instruments involved are entirely conventional in form and contain no ambiguity on their face. In such a case we think the problem is not one of ascertaining "intent," since the parties have objectively manifested their intent. It is a

problem of whether the intent and acts of these parties should be disregarded in characterizing the transaction for federal tax purposes.'

This is not like the case of *Rowan* v. *United States,* 5 Cir., 219 F.2d 51, decided by this court, in which there were facts and circumstances that were ambiguous. There we said that the element of intent was necessary because in that case there were advances made that could, according to the intent of the parties, be either contributions to capital or loans to be repaid. In such a case, of course, the "intent" of the parties could be controlling.

We commence with the undisputed proposition that the relationship between a corporate taxpayer and its stockholders may be absolutely clear and binding so far as their relationships are concerned, but that for income tax purposes, such relationships may be something quite different. As stated by Judge Learned Hand in his dissenting opinion in *Gilbert* v. *Commissioner,* 2 Cir., 248 F.2d 399 (dealing with a legal proposition not in dispute in that case between him and the majority of the court), "However, it is also settled that, although the rights of a taxpayer may be absolute as between himself and his corporation, the law will at times refuse to regard those rights in assessing his income tax. That doctrine stems from *Gregory* v. *Helvering,* 293 U.S. 465; at least that is the source usually ascribed to it. It is a corollary of the universally accepted canon of interpretation that the literal meaning of the words of a statute is seldom, if ever, the conclusive measure of its scope."

In *Gregory* v. *Helvering,* a case in which the Supreme Court had for decision the question whether a corporate reorganization had taken place under the terms of Section 112 of the Revenue Act of 1928, with the attendant tax benefits resulting from such reorganization, the Court

concluded that while there was in fact every step that was required to be taken to result in a corporate reorganization, there was, nevertheless: "Simply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object in accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of the corporate shares to the petitioner." The Court held that the taxpayer's plan could not succeed because "the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose."

So, too, here, the government contends that to hold this document to create an indebtedness "lies outside the plain intent of the statute." The government places its argument principally on the proposition that these subordinated debentures created rights in the holders that do not significantly vary from those of preferred stockholders.

Taxpayer counters with the argument that the courts have repeatedly held that an "indebtedness" may be validly created by the advance of money by stockholders to their wholly owned corporation; that the identity of ownership does not, *of itself,* prevent the advance from being treated as an indebtedness. This, of course, is undisputed. This was fully recognized by this court in *Rowan* v. *United States, supra.* The government does not dispute this basic proposition. It is, however, a circumstance to be considered when there are additional facts that cast doubt on the transaction.

Next, says the taxpayer, the *mere fact* of subordination of the indebtedness to all other creditors does not change

the obligation into an investment in the company's capital. This, too, must be without dispute, bearing in mind, of course, that the proposition is that subordination *standing alone* does not change the character of the obligation.

The difficulty here is that this is not simply a case of an attempt to create a debt relationship between the sole stockholders and their corporation, nor is it simply a case of a debenture being subordinated to other creditors. It is *both* of these things. Moreover, it contains a number of other characteristics which, when taken together, we conclude go farther towards eliminating any difference between the holders of these debentures and preferred stockholders than any case that has been called to our attention. One of these is the long term (20 years) of the debentures; another is the fact that they are unsecured; another is the absence of any limitations on the amount of payment of dividends and the absence of provision for any sinking fund or reserve out of which payment *after all other obligations are paid,* can be reasonably assured.

The taxpayer relies heavily on the case of *Commissioner of Internal Revenue* v. *O. P. P. Holding Corporation,* 2d Cir., 76 F.2d 11. However, there is a very significant circumstance in that case which does not appear here. There the corporation obligated itself to pay no dividends to its stockholders as long as any interest payments on the debenture bonds remained unpaid. Here the contrary is true. Every dollar of net profits each year during the twenty-year period could be paid out in dividends to the common stockholders without objection from the holders of these "debentures."

The taxpayer further relies on *John Kelley Company* v. *Commissioner of Internal Revenue,* 326 U.S. 521, in which case the Supreme Court reversed the judgment of the United States Court of Appeals for the Seventh Circuit,

with an opinion written by then Circuit Judge, later Mr. Justice Minton, and reinstated a decision of the Tax Court, 1 T.C. 457. While it is true that the facts in the case of the *John Kelley Company,* in which the taxpayer prevailed, are somewhat similar to those in the case before us, it must be pointed out that this case has no precedential value beyond that of any other decision of the Tax Court, because the Supreme Court decision finally affirming the Tax Court's decision, was based on the *Dobson* rule, *Dobson* v. *Commissioner,* 320 U.S. 489, which was to the effect that the Courts of Appeal should not reverse decisions of the Tax Court where the expertise of the judges of that court may be considered to have an important bearing upon its decisions. It must be borne in mind that the 1948 amendment to Section 1141(a) of the Internal Revenue Code of 1939 repealed the rule of *Dobson* and made decisions of the Tax Court reviewable by Courts of Appeals in the same manner as decisions of the District Court. See *Benton* v. *Commissioner,* 5 Cir., 197 F.2d 745.

Moreover, the *Kelley* case was a companion case in the Supreme Court with the case of *Talbot Mills* v. *Commissioner of Internal Revenue.* In the *Talbot Mills* case the Supreme Court affirmed the judgment of the Court of Appeals for the First Circuit in line with the *Dobson* rule, because that appellate court had in turn affirmed a decision of the Tax Court. In the *Talbot Mills* case the Tax Court, on slightly different facts, had held that the debentures that were in all essential details similar to the debentures in the *John Kelley Company* case, except that the payments of interest were not cumulative (see 326 U.S. 521-523) were not "indebtedness", but amounted to preferred stock.

Here the government lays great stress upon the fact that the provisions of these debentures relating to the subordination of this obligation to pay off all other creditors

of the company whenever such other debts are created, make practically ineffectual what otherwise appears to be an absolute obligation to pay interest regularly and to pay the principal on a specified date. It is plain, as the government points out, that the holders of the "debentures" are practically helpless if the Snyder Bros. Company should decide, for any reason, not to pay interest when due or the principal on its maturity date. In such event, the company is under contractual obligation to notify all the existing creditors, and all of the outstanding debts of the company, whether of later maturity date or not, automatically become due and payable in advance of any payments to the debenture holders. Whether this would, in fact, be a means by which the company could coerce the debenture holders into agreeing to an extension of the otherwise specific dates of payment, it is plain that the hazard of forcing collection upon default[2] makes much less certain that the debentures will be paid off in accordance with their terms than is apparent simply from the face of the debentures themselves.

Recognizing, as we must, that there is nothing to guarantee to the debenture holders that they can collect the face amount of the debentures, or even collect a past-due payment, without forcing the company into liquidation in the sense that it will be required to raise sufficient cash to pay off all its existing creditors including the debenture holders, and recognizing the well known economic fact stated so succinctly by appellee's counsel in their brief that even all ordinary creditors, who have a right to share *pari passu*, rarely get the face amount of their claims, we think it is plain that upon the admitted facts of this

2. Such a hazard is certainly recognized by the appellee in this case, for counsel say in their brief here: "It is a matter of common knowledge that when businesses go into bankruptcy or receivership the creditors frequently receive only a small percentage, or nothing, on their claims."

record the documents denominated "subordinated debentures" do not create the kind of "indebtedness" which Congress had in contemplation in enacting Section 163.

What we have decided here is wholly consistent with the decision of this court in *United States* v. *South Georgia Railroad Company*, 5 Cir., 107 F.2d 3. It is in no way inconsistent with the decision of this court in *Rowan* v. *United States, supra.* While it is true that in the *Rowan* case we decided that the advances there did create an indebtedness within the contemplation of the statute, we called attention to the fact that a number of the circumstances that are present in this case were not present in the relationship between the stockholders and their corporation there. For instance, we said: "There are in this case none of the facts authorizing other inferences to be drawn, such as that the initial payments, both capital and advances, were all made for acquisition of capital assets, as in Commissioner of Internal Revenue v. Meridian and Thirteenth Realty Company, 7 Cir., 132 F.2d 182, and Matthiessen v. Commissioner, 2 Cir., 194 F.2d 659 [It will be remembered that in this case both capital and advances "were made for acquisition of capital assets."]; . . . or subordination to other indebtedness [Here, to the contrary, there is subordination to all other indebtedness]; or inordinately postponed due-date [Here there is a 20 year due-date before which no claim can be asserted against the corporation]; . . . or payment of advances as initial funds to start the corporate life, as in Janeway v. Commissioner, 2 Cir., 147 F. 2d 602, [Here, to the contrary, the payment of the amount representing the $140,000 of debentures by transfer of the partnership interest to the corporation, did stand as "initial funds to start the corporate life."], one of which or a combination of which is present in the usual case of this type that comes

before the appellate courts" 219 F.2d 51, at page 55. Thus it is apparent that a number of the things are present in the case before us that we specifically noted were not present in the *Rowan* case. The net of the matter is that for us to construe this document under these circumstances as an "indebtedness" would be to give substance to a "transaction [which] upon its face lies outside the plain intent of the statute" 293 U.S. 465, 470.

The Judgment is REVERSED and the case is REMANDED to the District Court for the entry of judgment in favor of the United States.

APPENDIX

to

No. 22,111

UNITED STATES v. SNYDER BROTHERS COMPANY

6% Subordinated Debenture
Snyder Brothers Company
Toccoa, Georgia

DUE DECEMBER 1, 1977

For value received, the undersigned SNYDER BROTHERS COMPANY, a Georgia Corporation, and herein referred to as "The Company" hereby promises to pay to the registered holder hereof, on December 1, 1977, at the principal office of the Company in Toccoa, Georgia, the principal sum of Five Thousand and No/100 Dollars with interest from date at Six per cent per annum, payable semi-annually on June 1 and December 1 in each year.

This debenture is transferable only on the books of the Company by proper written assignment duly executed by the registered holder hereof and the presentation of this debenture at the office of the Company in Toccoa, Georgia, for notation of such transfer hereon and on the books of the Company. The Company may deem and treat the registered holder of this debenture as the absolute owner thereof for all purposes. The Company may make payment of interest hereon by mailing check to the registered holder at the address shown on the books of the Company, provided such check is duly paid upon due presentation thereof to the bank on which drawn. The Company may refuse to make any requested transfer until furnished with evidence satisfactory to it that the transfer

has been duly executed by the registered holder hereof and that such registered holder is duly authorized to make such requested transfer.

The Company shall have the privilege of redeeming this Note at any time prior to maturity at the office of the Company in Toccoa, Georgia, by giving 30 days notice in writing by mail addressed to the person in whose name this Note is registered and by paying the principal amount thereof plus accrued interest.

This Note is one of a series of Subordinated Debentures (hereinafter referred to as "Notes") aggregating $140,000.00 in principal amount, issued or about to be issued by the Company, all of which will become due on December 1, 1977. All the Notes of this series are payable pari passu, and the holders shall have no preference over each other.

Anything in this Note to the contrary notwithstanding, the indebtedness evidenced by this Note and all Notes of this series shall be subordinate and junior in right of payment, to the extent and in the manner hereinafter set forth, to all indebtedness of the Company whether outstanding at the date of this Note or incurred and not subordinated after the date of this Note, (such indebtedness of the Company to which the Notes are subordinate and junior being sometimes hereinafter referred to as "Superior Indebtedness"):

(a) In the event of any insolvency or bankruptcy proceedings, or any receivership, liquidation, reorganization or other similar proceedings in connection therewith, relative to the Company or to its creditors, as such or to its property, and in the event of any proceedings for voluntary liquidation, dissolution or other winding up of the Company, whether or not involving insolvency or bankruptcy, then the holders of the Superior Indebted-

ness shall be entitled to receive payment in full of all principal and interest on all Superior Indebtedness before the holders of the Notes are entitled to receive any payment on account of principal or interest upon the Notes, and to that end the holders of the Superior Indebtedness shall be entitled to receive for application in payment thereof any payment or distribution of any kind or character, whether in cash or property or securities, which may be payable or deliverable in any such proceedings in respect of the Notes; and

(b) In event the principal or any interest payment on these Notes becomes in default, then the holders of the Superior Indebtedness outstanding at the time of such default shall be entitled to receive payment in full of principal and interest on all Superior Indebtedness before the holders of the Notes are entitled to receive any payment on account of the principal or interest upon the Notes.

No present or future holder of Superior Indebtedness shall be prejudiced in his right to enforce subordination of the Notes by any act or failure to act on the part of the Company. The provisions of the preceding paragraph and its two sub-paragraphs are solely for the purpose of defining the relative rights of the holders of Superior Indebtedness on the one hand, and the holders of the Notes on the other hand, and nothing herein shall impair, as between the Company and the holder of any Note, the obligation of the Company, which is unconditional and absolute, to pay to the holder hereof the principal and interest thereon in accordance with its terms, nor shall anything herein prevent the holder of a Note from exercising all remedies otherwise permitted by applicable law or hereunder upon default, subject to the rights, if any, under the preceding paragraph and

its two sub-paragraphs of holders of Superior Indebtedness to receive cash, property or securities otherwise payable or deliverable to the holders of the Notes.

The Company agrees, for the benefit of the holders of Superior Indebtedness, that in the event the principal or any interest payment on this Note becomes in default:

(a) The Company will give prompt notice in writing of such happening to the holders of Superior Indebtedness, and (b) all Superior Indebtedness shall forthwith become immediately due and payable upon demand, regardless of the expressed maturity thereof.

IN WITNESS WHEREOF, Snyder Brothers Company has caused this Note to be executed in its name by its President and attested by its Secretary, and its seal affixed, at Toccoa, Georgia, this December 2nd, 1957.

SNYDER BROTHERS COMPANY (SEAL)
By (Floyd R. Snyder) /s/

ATTEST:
/s/ (Franklin D. Snyder)

GEWIN, Circuit Judge, Dissenting:

The majority opinion is anchored to two premises which I conceive to be misconceptions of the law, and therefore I respectfully dissent.

The misconceptions mentioned are expressed in the following language:

> (a) "The difficulty here is that this is not simply a case of an attempt to create a debt relationship between the sole stockholders and their corporation, nor is it simply a case of a debenture being subordinated to other creditors. It is both of these things."

(b) "It is plain, as the government points out, that the holders of the 'debentures' are practically helpless if the Snyder. Bros. Company should decide, for any reason, not to pay interest when due or the principal on its maturity date."

The cases on this subject are myriad, and it is readily admitted that the question presented is difficult. In many cases of this nature the pertinent inquiry relates to whether the parties *intended* to create a debt or to make a capital investment. For example in *Rowan* v. *United States* (5 Cir. 1955) 219 F.2d 51 at 54 we stated:

> "But, it is said that whether an advance is a loan or is capital depends on the intent of the parties, and this intent is to be ascertained from all relevant facts and circumstances. In stating this proposition, the brief for the United States cites two cases decided by this Court, Arnold v. Phillips, 5 Cir., 117 F.2d 497 and United States v. South Georgia Ry. Co., 5 Cir., 107 F. 2d 3. This is undoubtedly the law. . . ."

This issue is not present in this case, however, because in its reply brief the Government states that *intent* is not an issue to be resolved but that the only question is whether the debentures *on their face* constitute an "indebtedness."[1]

---

1. In its original brief the Government appeared to raise the question of intent by the following language:

> "In the instant case, it is clear that the Snyder brothers *intended* to and actually did commit the partnership assets that they transferred to the corporation upon its organization to the risks of the corporate venture." (Emphasis added)

In its reply brief here, however, the following statement is made:

> "On the other hand, in the instant case the *intent* of the parties is not at issue, for there is no contention that the 'Debenture' holders would not seek to enforce the 'Debentures' to the extent that the terms of the 'Debentures' permitted this. Whether the 'Debentures' constituted a capital investment or indebtedness depends not on a determination of anyone's *intent* but rather on a characterization of the instrument here involved." (Emphasis added)

It is the Government's position that the debentures are not an "indebtedness" because there is, in effect, *no fixed date* at which the obligation of the taxpayer to pay principal and interest can be enforced by the holders. It arrives at this conclusion through the following rather tortuous exegesis of the terms of the securities themselves. The debentures state that upon failure to pay either principal or interest, all superior creditors "shall be entitled to receive payment in full" before the debenture holders "shall be entitled to receive any payment . . ." The Government construes this language to mean that all superior creditors *must be paid in full before the debenture holders can enforce their rights.* Thus, payment on the securities can be indefinitely postponed by the failure (through collusion or complacency) of any single superior creditor to demand his money; and the corporation can extort an infinite number of *extensions* on the debentures by simply threatening a default which would give rise to such a situation.

It is quite clear that subordination standing alone does not destroy "indebtedness."[2] *Commissioner* v. *O.P.P. Holding Corp.*, 76 F.2d 11, 12 (2 Cir., 1935). See also *John Kelley Co.* v. *Commissioner*, 326 U.S. 521 (1946); *Kraft Foods* v. *Commissioner*, 232 F.2d 118, 125-6 (2 Cir. 1956).

---

2. In effect the Government recognizes this principle by the following statement in its initial brief:

> "This is not to say that one advancing funds to a corporation cannot subordinate his claim to certain claims of other creditors and still be a creditor of the corporation. One who is unwilling to commit his funds to the risks of the corporation's business may still be willing to allow certain of its other obligations to be satisfied out of its assets prior to satisfaction of his own claim, where it appears that there would still be sufficient assets to provide security for his own claim."

I find the following language from the Second Circuit in *Commissioner* v. *O.P.P. Holding Corp., supra,* at page 12 to be the most pertinent expression available on the nature of an "indebtedness" as distinguished from an equity investment:

> "We do not think it fatal to the debenture holder's status as a creditor that his claim is subordinated to those of general creditors. The fact that ultimately he must be paid *a definite sum at a fixed time* marks his relationship to the corporation as that of creditor rather than shareholder. The final criterion between creditor and shareholder we believe to be the *contingency* of payment. The shareholder is entitled to nothing, prior to liquidation, except out of earnings. Even on liquidation, at least in New York, arrears of cumulative dividends are confined to earnings. Michael v. Caycy-Caguas Tobacco Co., 190 App. Div. 618, 180 N.Y.S. 532. These debenture bondholders were not so limited. The interest could be deferred, but it was not lost, though the company had no earnings; it could be collected, together with the principal, in 1954, from the corpus of the debtor's property, regardless of whether there should be a surplus. See Warren v. King, 108 U.S. 389, 399, 2 S.Ct. 789, 27 L.Ed. 769. This distinction marks the vital difference between the shareholder and the creditor. The shareholder is an adventurer in the corporate business; he takes the risk, and profits from success. The creditor, in compensation for not sharing the profits, is to be paid independently of the risk of success, and gets a right to dip into the capital when the payment date arrives." (Emphasis added)

See also *Rowan* v. *United States, supra.* In the present case, there is an *expressed* obligation to pay principal and interest at fixed dates. Therefore, the ultimate question is whether, as the Government contends, the debentures are so worded that payment can be postponed or extended *indefinitely* so as to avoid payment as a matter of law.

While it is true that the debentures provide that superior creditors shall be paid in full before the holders can receive any payment, they also expressly reserve to the holders *all other rights* available at law. The law of Georgia controls the remedies of the debenture holders as against the corporate taxpayer. Notwithstanding the subordination provision, they also clearly and unequivocally provide that nothing shall impair the unconditional and absolute obligation of the company (taxpayer) to pay to the holders of the debentures the principal and interest, or diminish the legal remedies of the holders upon default.

The majority seems to admit that the creation of a debt between the debenture holders and the corporation in the circumstances here present would not be objectionable. Likewise, it is admitted that subordination is not fatal to the taxpayer's position. But the majority will not tolerate both. I cannot agree. Such reasoning will allow a debt but never subordination. Subordination is not condemned but is an approved business practice. The taxpayer usually gets in trouble when the facts show a "thin incorporation" where the ratio of capital to debt financing reflects a gross imbalance; where there is an absence of business purpose in the transaction; or when the value of the property transferred to create the debt is less than the amount of the debt created. The facts and circumstances of this case clearly show an absence of any of these condemned practices. There is not present any capital and debt imbalance; there is a valid business purpose; and no one has questioned the value of the assets transferred.

I construe these provisions simply to mean that whenever there is default on the debentures, all other indebtedness becomes due and all superior creditors are to be given a *preference* in payment over the debenture holders.

I discern nothing therein which would prevent a debenture holder from obtaining payment, either from earnings or surplus, once the superior indebtedness is paid.[3] Nor is there any reason why the holders could not sue to enforce the obligations, even if the superior creditors fail to demand payment.

The majority is simply in error when it agreed with the Government that the debenture holders "are practically helpless" if the taxpayer refuses to pay principal or interest when due, "for any reason". The law of Georgia is clearly to the contrary. A recent Georgia case so holds. *Commercial M & F Corp.* v. *North American Investors,* 141 S.E.2d 768 (Ga.Ct.App. 1965).[4] In Georgia, an obligee can sue on an instrument containing a subordination clause and obtain a judgment. Unless there is a provision in the subordination agreement which precludes suit on the instrument. The cited Georgia case holds that it is immaterial in a suit seeking judgment that there are any outstanding claims of general creditors of the maker on the date payment is due on the note. In the event judgment is recovered, the provisions of the subordination agreement might affect the *enforcement* and *collection* of the judg-

3. It is significant to note that factually the business involved was apparently a successful and lucrative one. During the last five years of its existence the partnership earnings ranged from approximately $45,000 to $96,000 per year, and in 4 of the 5 years the annual earnings exceeded $80,000. The taxable income of the corporation for the fiscal years 1959 and 1960 was $78,586 and $38,743 respectively. The accumulated earnings at the end of fiscal 1960 were $84,751.00 and its net worth was $192,461.00. After the corporation was organized and the debentures were issued, its net worth was approximately $108,000.00 based on book values.

4. The Court makes incidental reference to the fact that the subordination agreement involved terminated on the due date of the note. The opinion, however, seems to be based on an assumption that collection of the note was subject to the subordination agreement.

ment, but would not constitute a bar to *obtaining judgment*. Only *other creditors* can then raise the subordination provision as an obstacle to the enforcement of the judgment. In short, the taxpayer here has a definite legal obligation to pay principal and interest *at a fixed date*, and the debentures *on their face* constitute a valid indebtedness. The majority opinion fails to consider this important case in the Georgia jurisprudence. The judgment of the District Court should be AFFIRMED.

United States Court of Appeals

FOR THE FIFTH CIRCUIT

OCTOBER TERM, 1965

No. 22111

D. C. Docket No. 1000—Civil Action

UNITED STATES OF AMERICA,
Appellant,

versus

SNYDER BROTHERS COMPANY,
Appellee.

Appeal from the United States District Court for the Northern District of Georgia.

Before TUTTLE, Chief Judge, GEWIN, Circuit Judge, and HUGHES, District Judge.

Judgment

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Georgia, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, reversed; and that this cause be, and it is hereby remanded to the said District Court for the entry of judgment in favor of the United States.

GEWIN, Circuit Judge, Dissents.

July 26, 1966

Issued as Mandate: October 5, 1966.

IN THE

United States Court of Appeals

FOR THE FIFTH CIRCUIT

No. 22111

UNITED STATES OF AMERICA,
Appellant,

versus

SNYDER BROTHERS COMPANY,
Appellee.

Appeal from the United States District Court for the Northern District of Georgia.

(September 27, 1966.)

On Petition for Rehearing

Before TUTTLE, Chief Judge, GEWIN, Circuit Judge, and HUGHES, District Judge.

BY THE COURT: By its motion for rehearing, appellant [sic] complains that in our opinion we stated, "We conclude that the issue here to be decided is one of law." In appellee's post-argument brief, it is stated, "We again call attention to the fact that the Government now states that the only issue in this case is whether the debentures on their face constitute indebtedness. . . . On that assumption, it is clear, as the court noted on oral argu-

ment, that there is no question of fact for the jury, since the interpretation and construction of a contract is a question of law for the courts. Ga. Code, Section 20-701 (1933); *Williston on Contracts,* Section 616, Note 7; *Encyc. of Georgia Law: Contracts,* Section 51." The only question before the court here is whether the debentures on their face constitute indebtedness when issued under the circumstances of this case, as to which there is no dispute of fact. Thus there is nothing before the court except a legal question.

As a matter of law, the debentures here in question do not create a "debt" within the contemplation of the applicable statute.

The motion for rehearing is DENIED.

GEWIN, Circuit Judge, Dissents.

APPENDIX B

COMMISSIONER OF INTERNAL REVENUE v. O.P.P. HOLDING CORPORATION.

No. 220.

Circuit Court of Appeals, Second Circuit.

March 4, 1935.

Appeal from the Board of Tax Appeals.

Petition by the Commissioner of Internal Revenue to review an order of the Board of Tax Appeals determining that there was no deficiency in the income tax of the O.P.P. Holding Corporation for the fiscal year ending July 31, 1930.

Order affirmed.

For the opinion below, see 30 B. T. A. 337.

Frank J. Wideman, Asst. Atty. Gen., and Sewall Key and Thomas A. Carpenter, Sp. Assts. to Atty. Gen., for petitioner.

Louis A. Garvelle, of Washington, D.C. (A. Loeb Salkin, of New York City, of counsel), for respondent.

Before L. HAND, SWAN, and CHASE, Circuit Judges.

SWAN, Circuit Judge.

This case involves the income tax liability of O.P.P. Holding Corporation, hereafter referred to as the taxpayer, for the fiscal year ending July 31, 1930. The Commissioner disallowed a deduction of $20,000 from gross income which the taxpayer claimed to be a payment of interest on its debenture bonds. The Board of Tax Appeals reversed

this determination, with the result that no deficiency in tax exists. The Commissioner has appealed.

The taxpayer was incorporated under the laws of New York on June 20, 1929, with an authorized capital of $20,000, consisting of 2,000 common shares. On June 25th it purchased all the capital stock of Oneida Paper Products, Inc., a New York corporation, and paid the sellers thereof 1,000 shares of its own stock and $250,000 of its debenture bonds dated as of July 1, 1929, maturing June 30, 1954, and bearing interest at 8 per cent per annum. The stock of Oneida Paper Products, Inc., had a book value of $129,785.51, taking the inventories and fixed assets at cost and including nothing for good will. A schedule of net sales, net income, and compensation to officers shows that the Oneida Company has enjoyed a progressive increase in its business and had a net income of $26,000 for the year ending July 31, 1929. On its books the taxpayer set up on the asset side the Oneida stock at $260,000, and on the liability side put its debenture bonds at $250,000 and its capital stock at $10,000. Payments on the bonds were always recorded as "interest." During the fiscal year ending July 31, 1930, the taxpayer received a dividend of $20,000 on the Oneida stock. During the same period it paid to holders of its debenture bonds the sum of $20,000 as interest. The taxpayer and its wholly owned affiliate, Oneida Paper Products, Inc., filed a consolidated income tax return, including in gross expense the said interest payment on the debenture bonds. This deduction the Commissioner disallowed on the theory that it represented a dividend payment, since he regarded the bonds as of the nature of preferred stock. The Board disagreed with his ruling. The sole question is whether the "interest" payment constituted a legal deduction under Section 23(b) of the Revenue Act of 1928 (45 Stat. 799, 26 USCA §2023(b)). See, also, Treas. Reg. 74, Art. 141.

[1] The debenture bonds contain certain unusual provisions upon which the petitioner strongly relies in urging that they should be treated as certificates of preferred stock. They are subordinated, both as to principal and interest, to the claims of all other creditors; and the company may at its option suspend or defer the payment of interest, "but such suspension of payment shall in nowise relieve the Corporation of the obligation to pay the same at some future time." It was also provided that the company should pay no dividend upon its stock unless all interest on its debenture bonds should have been paid in full. The bonds had a definite maturity date (unless sooner called), namely, June 30, 1954, although holders of two-thirds of the outstanding bonds might extend the date for all.

We do not think it fatal to the debenture holder's status as a creditor that his claim is subordinated to those of general creditors. The fact that ultimately he must be paid a definite sum at a fixed time marks his relationship to the corporation as that of creditor rather than shareholder. The final criterion between creditor and shareholder we believe to be the contingency of payment. The shareholder is entitled to nothing, prior to liquidation, except out of earnings. Even on liquidation, at least in New York, arrears of cumulative dividends are confined to earnings. Michael v. Caycy-Caguas Tobacco Co., 190 App. Div. 618, 180 N.Y.S. 532. These debenture bondholders were not so limited. The interest could be deferred, but it was not lost, though the company had no earnings; it could be collected, together with the principal, in 1954, from the corpus of the debtor's property, regardless of whether there should be a surplus. See Warren v. King, 108 U.S. 389, 399, 2 S.Ct. 789, 27 L.Ed. 769. This distinction marks the vital difference between the shareholder and the creditor. The shareholder is an adventurer in the corpo-

rate business; he takes the risk, and profits from success. The creditor, in compensation for not sharing the profits, is to be paid independently of the risk of success, and gets a right to dip into the capital when the payment date arrives. The courts have very frequently been called upon to determine whether the rights of a claimant are those of shareholder or creditor. Each case has turned on its special facts, and to cite them all would not be useful, if it were possible. We think all the decisions which we have examined may be harmonized by adopting the criterion above suggested. The decision of this court in Re Fechheimer Fishel Co., 212 Fed. 357, is entirely consistent with this view. There interest on the so-called bonds was to be paid only out of earnings, and upon liquidation or dissolution the whole residue of the corporate assets after payment of the debts was to go to the bondholders. Hazel Atlas Glass Co. v. Van Dyk & Reeves, 8 F.2d 716 (C.C.A. 2), has nothing to the contrary. In Kentucky River Coal Corp. v. Lucas, (D.C.) 51 F.2d 586, affirmed, 63 F.2d 1007 (C.C.A. 6), the "debenture stock" was to receive dividends only out of earnings, and the court held that the undertaking to redeem it at par at the end of ten years did not make it a debt rather than stock. Fidelity Savings & Loan Ass'n v. Burnet, 62 App. D.C. 131, 65 F.2d 477, and Finance & Investment Corp. v. Burnet, 61 App. D.C. 78, 57 Fed. 444, are similar. Compare Arthur R. Jones Syndicate v. Com'r, 23 F.2d 833 (C.C.A. 7); Wiggin Terminals, Inc. v. United States, 36 F.2d 893 (C.C.A. 1).

Armstrong v. Union Trust & Savings Bank, (C.C.A.) 248 Fed. 268, Elko Lamoille Power Co. v. Commissioner, (C.C.A.) 50 F.2d 595, and In re Culbertson's, 54 F.2d 753, 757, all in the Ninth Circuit, involved certificates with essential characteristics similar to the debenture bonds issued by the taxpayer. The certificates yielded a fixed rate of

return which was cumulative and payable before the common stock. The instruments were silent as to whether or not their return was payable solely out of profits, but there was evidence in the Culbertson case that over a long period of time dividends had been regularly paid irrespective of actual earnings. Provision was made for the redemption or retirement of the certificates at the end of a special period. In each case the contention that the holders of the instruments in question should be considered creditors of the issuing company was rejected, and the certificates were held to be preferred stock. The "agreement to pay dividends at stated intervals" was construed in the Culbertson case to be "an agreement to pay the same from the profits." The only substantial distinction between those certificates and the debenture bonds now before the court is one of nomenclature; the former had been denominated preferred stock. The petitioner urges that the name given to an instrument is not controlling, but that its inherent characteristics will determine its true nature and legal effect. This may be conceded, but it does not follow that the name by which the certificates are designated is to be completely ignored. Stocks and bonds both evidence a contract between their holders and the issuing corporation, and, in construing this contract, the language used in reducing it to writing will be indicative of the intention of the parties. See Spencer v. Smith, 201 Fed. 647, 651 (C.C.A. 8). Though both contain substantially similar provisions and are silent as to the source of the return, it is not inconsistent to hold that only in the case of certificates designated as bonds were the holders intended to be creditors of the corporation and the return to be interest payable irrespective of actual earnings. In our opinion the Board correctly held that the debenture holders were creditors and the interest payment a proper deduction.

[2] The petitioner further contends that the transaction out of which the debenture bonds were issued constituted a device for the distribution of income in the guise of interest at a high rate on inflated principal. He bases this charge on the fact that the taxpayer valued at $260,000 stock of Oneida Paper Products, Inc., which the latter had valued on its own books at $129,785.51. However, as has been indicated, the balance sheet from which this figure was derived stated inventories and fixed assets at cost, and included nothing for good will or other intangibles. Since the net earnings of the Oneida Company had increased annually, and were 26 per cent for the year ending July 31, 1929, there was some justification for taxpayer's revaluation of the stock. The Board made no finding that the purchase was a device to reduce taxes.

The order is affirmed.

In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 893

SNYDER BROTHERS COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

This case presents the frequently recurring question whether a transfer of property by two stockholders to their wholly owned corporation created an "indebtedness" within the meaning of § 163(a) of the Internal Revenue Code of 1954, so that periodic payments by the corporation are deductible as "interest."

The two Snyder brothers operated a manufacturing business as equal partners. In 1957 they transferred all the partnership's assets to a newly formed

corporation (petitioner) in exchange for $100,000 of common stock, $140,000 of subordinated debentures, and the corporation's agreement to assume the partnership's $202,500 of liabilities. Under the terms of the subordinated debentures, the principal of $140,000 was payable in 20 years with six percent interest payable semiannually. However, payment of both principle and interest was subordinated to all other indebtedness of the corporation, whether already existing or incurred thereafter, without any limitation on the incurring of future debts. Moreover, there was also no limitation on the payment of dividends to stockholders, and no provision accelerating the maturity of the principal upon a default in interest payments. Finally, in case of any default in payment of either interest or principle on the subordinated debentures, all other indebtedness of the corporation would become immediately due and payable upon demand, regardless of the expressed maturity thereof, and would be entitled to payment in full before the holders of the subordinated notes received any payment. (Pet. A2, A13-16.)

The Commissioner took the position that the subordinated debentures were actually equity investments in the nature of preferred stock rather than "indebtedness" within the meaning of Code § 163, so that the so-called "interest" payments were actually non-deductible dividends. The district court directed a verdict for petitioner. The court of appeals reversed and directed entry of judgment in favor of the government. (Pet. A3-A4).

1. It is well established that dividends paid by a corporation on common or preferred stock are not deductible, but that interest paid by a corporation on "indebtedness" qualifies for a deduction. It is also clear that the incidence of taxation generally depends on the substance of a transaction and not on the label adopted by the parties. See, *e.g.*, *Gregory* v. *Helvering*, 293 U.S. 465; *Griffiths* v. *Commissioner*, 308 U.S. 355; *Higgins* v. *Smith*, 308 U.S. 473; *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260; *Knetsch* v. *United States*, 364 U.S. 361. This principle applies equally in the debt-versus-equity area. See, *e.g.*, *Foresun, Inc.* v. *Commissioner*, 348 F. 2d 1006, 1008 (C.A. 6); *Gilbert* v. *Commissioner*, 248 F. 2d 399, 402-404 (C.A. 2). Thus, a taxpayer who has transferred money or property to his corporation in exchange for what is in essence preferred stock cannot convert the periodic dividends into deductible interest merely by changing the label on the certificate. Especially where (as here) the so-called "debt" is issued to the stockholders in exactly the same proportion as their stock ownership in the corporation, the courts have subjected the transaction to careful scrutiny. *E.g.*, *Charter Wire, Inc.* v. *United States*, 309 F. 2d 878, 880 (C.A. 7), certiorari denied, 372 U.S. 965; *Arlington Park Jockey Club* v. *Sauber*, 262 F. 2d 902, 906 (C.A. 7). In fact, the courts have often concluded that a debt instrument which on its face appeared to have rights substantially different than preferred stock (*e.g.*, short maturity, no subordination, etc.) was, in light of the surrounding facts and circumstances, not entitled to any different treatment than preferred stock.

E.g., P. M. Finance Corp. v. *Commissioner*, 302 F. 2d 786 (C.A. 3); *Gooding Amusement Co.* v. *Commissioner*, 236 F. 2d 159 (C.A. 6), certiorari denied, 352 U.S. 1031.

In this case it is unnecessary to review all of the standards used in deciding whether shareholder notes which on their face are pure debt instruments actually do not constitute "indebtedness" within Code § 163, for (as the lower court held) the subordinated debentures here in question "go farther towards eliminating any difference between the holders of these debentures and preferred stockholders than any case that has been called to our attention" (Pet. A8). The entire $140,000 of subordinated debentures were issued to the Snyder brothers—the corporation's sole stockholders—in exact proportion to their stockholdings. These debentures are for a long term (20 years), they are unsecured, there is no sinking fund and no limitation on the amount of dividends the corporation can pay, the principal amount does not become due before the end of 20 years even if the corporation defaults in the payment of interest, and the debentures are completely subordinated to every other debt incurred by the corporation over the entire 20 year life.[1]

Moreover, even these minimal protections to the debenture holders are misleading. If the corporation ever defaults in the payment of any interest on the

---

[1] Since the lower court's decision depends solely on the rights which the debenture agreement afforded to their holders, the Snyder brothers subjective intent is not an issue in the case, and, contrary to petitioner's repeated assertions (Pet. 2, 9, 14, 16), the government has made no concession with regard to their subjective intention or motivation.

debentures, all of its other debts immediately become due and payable ahead of the debentures. Therefore, if the corporation were to ask the debenture holders to extend the due date for an interest or principal payment, there would be strong pressure on the holders to do so, for, if they refuse and the corporation defaults on the payment, all of its other debts will immediately become due and payable ahead of the debentures.

The court below properly concluded that to construe the subordinated debentures as representing an "indebtedness" within the meaning of § 163—and thus to give a deduction for "interest" paid on these debentures while denying a deduction for fixed dividends paid on preferred stock—would be to give substance to a transaction which upon its face lies outside the plain intent of the statute (Pet. A12).

2. The decision below does not conflict with *John Kelley Co.* v. *Commissioner*, 326 U.S. 521. In *Kelley* this Court declined to pass on the question here in issue, saying that under the then applicable *Dobson* rule the appellate courts should accept the Tax Court's decision on such matters, since the expertise of the Tax Court judges lay "primarily in their ability to examine relevant facts of business to determine whether or not they come under statutory language." 326 U.S. at 529.[2]

---

[2] The *Dobson* rule, limiting the scope of appellate review of Tax Court decisions, has since been overruled by Congress. See 26 U.S.C. § 7482(a), making the decisions of the Tax Court reviewable by courts of appeals in the same manner as decisions of the district courts.

There is no conflict between the decision below and the cited decisions of the Court of Appeals for the Second Circuit (Pet. 10). The subordination provisions in the cited cases were more limited than in the instant case.[3] Moreover, in *Commissioner* v. *O.P.P. Holding Corp.*, 76 F. 2d 11 (C.A. 2), upon which petitioner heavily relies, the corporation obligated itself to pay no dividends so long as any interest payment was in default. Here, on the other hand, even after a default in an interest payment the debenture holders could not prevent petitioner from paying dividends (as long as petitioner was not insolvent).[4]

---

[3] If for any reason petitioner does not make an interest payment on the subordinated debentures when due, it is under contractual obligation to notify all of its existing creditors; and all of its outstanding debts, whether of later maturity date or not, automatically became due and payable before any payments can be made to the debenture holders. Thus, even if petitioner is not insolvent or in the process of liquidation, the debenture holders have no assurance that they can collect a payment due under the debentures without forcing the petitioner into liquidation in the sense that it will be required to raise sufficient cash to pay off all its existing creditors. Moreover, since the due date of the debentures is not accelerated in case of a default in an interest payment, a debenture holder would be compelled to require the corporation to pay off all of its existing creditors in order to enforce a single interest payment.

[4] Petitioner's statement (Pet. 12) that the corporation could not pay dividends while in default in the payment of interest on the debentures is incorrect. The textual authority relied on by petitioner (Pet. 12, fn. 22), 11 Fletcher, *Cyclopedia Corporations* (1958 Rev.), § 5324, and the cases cited therein hold only that a corporation cannot declare dividends when it is insolvent or when it will thereby become insolvent.

Finally, the Second Circuit has recently taken a more realistic approach to the determination of whether or not a note constitutes indebtedness for tax purposes. In *Nassau Lens Co.* v. *Commissioner*, 308 F. 2d 39, 46, 47 (C.A. 2), the court stated that "non-arm's-length loans by a stockholder to a corporation are to be recognized or disregarded for tax purposes according to the extent to which they comply with arm's-length standards"; the court will inquire "whether outside investors would have made similar advances," and treat a shareholder loan as "indebtedness" only if it "can be said to be debt in terms of substantial economic reality." It is apparent that no outside creditor would have made twenty-year advances to petitioner corporation on the unsecured, subordinated terms contained in the debentures that were issued to its stockholders. Thus, there is no conflict between the instant decision and the decisions of the Second Circuit.

There is no other reason for further review. The decision does not hold, as petitioner contends (Pet. 15-16), that subordinated debt that is issued to stockholders can never constitute indebtedness for tax purposes. The court of appeals held only that where the subordination provisions are so broad that, when combined with the other circumstances that are here present, the position of a holder of the instrument is not substantially different from that of a preferred stockholder, the instrument does not constitute indebtedness in the practical reference of federal taxation.

The petition for a writ of certiorari should be denied.

Respectfully submitted.

THURGOOD MARSHALL,
Solicitor General.

MITCHELL ROGOVIN,
Assistant Attorney General.

HAROLD C. WILKENFELD,
SOLOMON L. WARHAFTIG,
Attorneys.

FEBRUARY, 1967.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1967 246798 642